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Data Release: House prices and debt levels still the key risks

- The Bank of Canada published its semi-annual Financial System Review (FSR) this morning. Both the risks identified and the threat they pose to the Canadian economy are unchanged relative to the June report.
- Elevated household debt and housing market imbalances remain the key domestic risks to the Canadian economy. While the household debt-to-income ratio has stabilized recently, it remains elevated relative to historic levels. The FSR also indicated that around 12% of households are extremely indebted, with debt-to-income ratios above 250% - a near doubling relative to 2000 levels. As regards the housing market, house price growth continues to outpace income gains, resulting in continued concerns regarding overvaluation. Indeed, Bank of Canada research included in the report suggests that house prices may be 10% to 30% overvalued at present. The FSR further highlights the regional nature of the housing risk, with rapid price growth in recent years driven by Vancouver, Calgary, and the Greater Toronto area. In terms of specific market risks, the FSR pointed to potential impacts on the Alberta real estate market should the recent decline in oil prices persist, as well as the elevated number of condo units under construction in Toronto creating the risk of an overbuild.
- Beyond the housing market, commercial real estate values have also accelerated in recent years. The cyclical nature of these markets, as well as the current high level of investment, creates a vulnerability for the Canadian financial sector.
- The external risks to Canada include financial stress from the euro area, as well as stress emanating from China and other emerging market economies. The Bank of Canada sees the likelihood of these events occurring as ‘medium’, unchanged from the June FSR.

Key Implications

- The December FSR was "more of the same" in terms of the risks facing the Canadian economy. In line with past reports, the Bank of Canada continues to identify elevated household debt and overvaluation in the housing market as the biggest risks to the financial system.
- In addition to focusing on these key risks, the FSR dedicated significant discussion to the negative impacts that higher long term rates could have in terms of causing the risks to be realized. This suggests that despite a string of recent positive economic data, the Bank of Canada is likely to be cautious in raising rates. As a result, we continue to expect the Bank of Canada to keep the policy rate unchanged until the final quarter of 2015.

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